CHAPTER VII

PUBLIC DEBT - NATIONAL DEBT

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Public Debts.

A common feature of all ~~large~~ modern State Enterprises

(1) Cheiff for war

(2) Partly for Extraordinary expenditure in connection with Re W.D.P. including

Early governments had only two sources of raising the national debts.

Present time almost everyone public debts; ~~but~~ ~~don't say~~ It is desirable if necessary within certain limits

(a). Ordinary Expenditure must be met by ordinary revenue from various State Sources of revenue

b). Extraordinary in connection with

(1) War
(2) Productive public works
(3). Temporary necessity

CHAPTER VII

PUBLIC DEBT - NATIONAL DEBT

I. Introduction:-

All large modern states have got large national debts, contracted

i) chiefly on account of wars and

ii) partly on account of extraordinary expenditures in connection with public works and public industries.

The national governments of the civilized world owed in 1910 the huge total of 7500 million sterling. This huge total has been multiplied many times by the enormous expenditures of different nations in the last world war; and problems relating to the public debts of nations are engaging the serious attention of nations and their governments.

In primitive society where commerce is small and manufacture scanty, governments make provision for future emergencies by hoarding from surplus revenue and not by borrowing from the people. These early governments had hoarded state treasures and they had no national debts. The growth of manufactures and commerce and the development of credit make it possible for a government to meet special emergencies

like wars, etc., by borrowing from the public and thus the system of national debts comes into existence. Professor Bastable has shown how this development goes hand in hand with the development of constitutional government.

Present theory does not regard public debts as inexhaustible mines of gold to be exploited at pleasure, nor does it condemn all public debts with indiscriminate censure. It recognises that in modern states, within certain limits, public debts are necessary and also desirable. Now what are these limits?

The present financial theory is that

(a) the ordinary expenditures of a state (those expenditures, which recur with sufficient regularity, so that they can be foreseen and estimated in advance) are to be met from the ordinary revenues which include receipts from public domain, public industries, fees, taxation, - or the state will become bankrupt

(b) and that the state should be allowed to meet extraordinary expenditures in connection with

i) special emergencies like wars

ii) productive public works, e.g., state railways, irrigation works, municipal gas works, water works, etc. from loans. War expenditures may be met partly from taxes and

partly from loans but expenditures on productive public works should be from loans only, and not from taxes - taxation for this purpose would mean an unnecessarily high level of taxation and would not be generally justified.

iii) The state may also borrow to meet a temporary necessity as when there is a deficit in the budget, the revenue of the year falling short of the expenditures for that year.

II. The Different Forms of Public Debt:-

(A) The temporary, floating or unfunded debt which is an advance to the government repayable by the government on the demand of the creditor, or within a comparatively short period.

Floating debts suffer from two disadvantages -

(a) they exercise a disturbing influence on the money market

(b) they are a source of embarrassment to the government because it is precisely at a time of difficulty that the strongest demand for repayment is likely to be made.

It is therefore an established financial maxim that the amount of a floating debt should be kept within narrow limits.

(B) The perpetual debt which is contracted without any date for repayment but repayable at any time at the pleasure of the government. It is in this shape that a great part of the debt of England, France, Italy and the German state exists.

The system of perpetual debt offers many important advantages to a government:-

The borrowing state is relieved from the risk of a sudden demand for the repayment of capital and has only to provide for the periodical payment of the interest on the capital. The state again is always able under this system to reduce as much of the debt as it wishes and has the power to repay and at the time most convenient to itself.

The creditor is also under no serious disadvantage because at any time he can realise the capital value of his loan by selling his stock in the stock market.

(C) Other miscellaneous forms of Public Debts.

III. Issue of a Public Debt:-

Certain considerations are to be borne in mind by the financier when he is going to issue a public loan. He will have to consider carefully the objections against public borrowing so that he might see whether he is justified under the circumstances of the case in disregarding these objections

and issuing a loan. And he should attempt to raise his loan in a way so to avoid as much as possible the evils attaching to public borrowing.

The weight of objections to public borrowing largely depends upon the purposes for which the money is borrowed. If the borrowing is for extravagant, wasteful expenditure or for the ordinary annual expenses of the government, then borrowing is not justified; and if it is for proper objects (i.e., for necessary expenditure on wars, on public works or for a temporary necessity) then prima facie it is justified.

Some objections to public borrowing are based on their political and economic effects.

1) Political:- The result of borrowing is to conceal from the nation the full financial effects of the policy of the government. Taxation instead of borrowing would make the effects quite clear to the people by increasing heavily the tax burden. In the case of weak states, the political status of the state may be endangered by the contraction of foreign loans. This has been the unhappy experience of many states in Asia.

2) Economic:- Public loans may divert capital from productive industries and thus injuriously affect the industrial future of the country. Steps should be taken as far as possible to see that the loans take national unin-

Taxes Vs. Loans :- Wealth can be raised by from citizens, by two means.

The ways of collecting are two
(a). Tax — direct
(b) Loans — indirect

Borrowing permissible for capital expenditure like dock, etc.
Certain conditions to be observed.
(a) If new capital is of profit earning capacity, annual revenue obtained from it must be sufficient to pay interest on money borrowed
(b). If non-profit earning, taxes must be levied to meet annual interest on the debt.
During war state borrows without concrete revenue to show how much it borrows — Increase of debt — Loans — Taxes

Differences
(1). Tax compulsory — Once paid gone forever
Loan voluntary — Return at future date with interest } Hence Loan preferable
(2). Taxes being compulsory evenly distributed:
Loans voluntary uneven. Rich get money (with it) from taxes from. Widened distribution of wealth
(3). Taxes paid out of income — Has an immediate reduced effect and Rhemic on loans.
(4). Inflation due to loans — leads to change in value of money.

uninvested capital and do not divert capital from productive industries.

The financier has to be careful also about the manner in which the debt is to be contracted. It has been seen that floating debts disturb the money market, and also are inconvenient for the government in certain respects, so floating debts should be kept as small as possible, and the government should depend mainly upon the funded debt. The debt should be also in a varied form so as to suit the needs of different classes of investors.

IV. Taxes Versus Loans:-

By whatever means the money is raised, the wealth utilized can come only from the citizens, but the ways in which it is collected have very different effects. There are two alternatives, taxes and loans. By a tax, the state compels citizens to give the amount required. By means of loans, the state tries to induce people to do so, and offers in exchange to pay an annual sum in interest until the total is repaid some time in the future.

It is one of the axioms of public finance that recurring expenditure should be borne by current revenue. Borrowing is permissible for capital expenditure, e.g., the building of docks and the construction of railways, provided certain conditions are observed. These conditions are:

1. If the new capital is of profit-earning capacity, the annual revenue obtained from it must be sufficient to pay the interest on the money borrowed and provide for upkeep and depreciation.

2. If it is non-profit-earning, taxes must be levied to meet the annual interest on the debt, and to provide sufficient to pay off the principal before the capital is worn out and new capital is required.

In war time the state is involved in expenditure with nothing concrete to show it. For sound finance, then, if money is raised by loans, there must at the same time be sufficient taxation to pay the interest on the loans and to pay off the whole of the debt before the next war necessitates further borrowing. Actually, of course, this has never been done. Governments have continued to pile one debt on another, until the total has at last reached colossal proportions, and needs an immense amount of taxation to meet even the annual charges.

Differences between Loans and Taxes:-

(1) A tax is a compulsory contribution. Once paid, it is gone for ever and the taxpayer feels it as a definite loss. A loan reduces the lender's resources for the moment but he has compensations in the interest and the thought of future repayment. As he forgets that it is he himself who

will have to be taxed to provide the funds for both interest and repayment he feels the loan less burdensome than the tax.

(2) Taxes, being compulsory are evenly distributed over all the citizens. Loans, being voluntary, are not. It is therefore the rich who are able to lend most, but the interest and repayment, provided out of taxation, must be drawn, at least in part, from the poor. Borrowing thus effects redistribution of wealth in favour of the rich.

(3) Taxes are generally paid out of income; the taxpayer reduces his own consumption by that amount. But lenders often borrow from the bank in order to lend to the government. This means that the government is provided with extra purchasing power and yet the citizen has not reduced his. Higher prices result with consequent industrial and social discreation.

(4) The inflation which thus results from borrowing leads to changes in the value of money and therefore, different amounts of real wealth are later repaid from what was borrowed. For instance, in England prices rose rapidly during the war owing to borrowing. After the war, when prices fall, the burden of the debt became much heavier. Every hundred pounds repaid now is of more value in terms of goods than the hundred pounds that was borrowed.

V. Redemption of Public Debt - Methods of Reducing Public Debt:-

Generally speaking the redemption of the public debt is desirable. As the state borrows money under great pressure and generally when it finds itself unable to raise funds by the agency of taxation, it is clear that the debt should not be made a permanent one and attempts should be made to redeem the debt at the earliest opportunity.

The subject of redemption may be considered under the three following heads:-

1) Redemption of the floating debt:- This is eminently desirable. A large floating debt disturbs the money market and is a source of embarrassment to the government. And when redemption is not possible, the greater part of it should be converted into funded debt.

2) Redemption of debts contracted for productive public works:- Every productive public work (e.g., a municipal telephone system or a municipal tramway or a municipal water-supply system) has a limited life, will last for a number of years and produce an income during these years. The redemption of the debt contracted for a productive public work should be carried out within the period during which the public work will produce its revenue; otherwise the future generation will be burdened with more than their just shares of the public debts.

3) Redemption of funded debt including non-productive debt:- This is best carried out by means of a sinking fund. The sinking fund is a fund accumulated for the redemption of the debt. It may be an annual fund (that is a portion of the annual income) or it is the accumulated capital from one or more sources for repayment of the debt. When a government is embarrassed for money and has to stop the work of redemption for a time, the sinking fund is suspended.

Redemption is desirable because -

Each period of national history has its own financial burdens to meet and the neglect of repayment in the present may increase dangerously the burden of debt for the future generations. The repayment of debt if properly carried out and if its amount is kept within the bounds set by the extent of suitable taxation will not press heavily upon tax-payers and will not weaken national power. Another advantage is that repayment of debt improves public credit and makes possible lowering the rate of interest on public loans and thus afford means for reducing taxation.

Methods of redeeming public debt :

1) Repudiation:- It is of course possible for the state to rid itself of the debt by repudiating it altogether. But the objections to this policy are insuperable. Firstly it discriminates between different forms of ownership of property - only those holding public securities will be compelled to undergo a loss to which the rest of the community are not

subject. Secondly it would result in great bitterness of feeling. Thirdly it would ruin the credit of the government so that in the future they would find it practically impossible to raise funds. Fourthly repudiation may lead to international complications since in most countries a part of the debt is held by foreign creditors.

Another type of repudiation is a forced reduction of interest. If a government raises a loan at 6 per cent and then arbitrarily reduces the interest to 3 per cent, the capital value of the security will be reduced by half. This type has all the disadvantages mentioned above.

2) Conversion:- By the conversion of a public debt is meant a modification of any of the terms agreed upon at its issue. It may be assumed that the Government is at liberty under the terms of the contract to effect changes and that the changes will be to its advantage. Commonly the conversion of a loan contemplates the substitution of a lower for a high rate of interest, by which the burden of the debt as measured by the annual payments which it occasions are lightened.

The process of conversion consists in converting or altering a loan bearing a given rate of interest into a loan at a lower rate of interest. Several important examples of conversion are to be found in the financial history of England, France, and the United States.

3) Sinking Fund:- The sinking fund is a fund accumulated for the redemption of the debt. It may be an annual fund formed out of the public revenue of the state or it may be the accumulated capital from one or more sources for repayment of debt.

4) A Capital Levy:- It has been proposed to repay the whole or greater part of the enormous war debts of the last great war by means of a big levy on capital. Those who are for this capital levy maintain that this levy on property is necessary because taxes on income alone are not sufficient to pay for the war and because excessively heavy income taxes will injure production and saving; secondly that it is just, because it will chiefly on old men who have much property and who unlike the young did not give their lives for the country and thirdly the debt would be rapidly repaid by this method before prices altered and therefore the same value would be returned as when borrowed. Those who are against the capital levy declare that such a charge would amount to repudiation, robbery and confiscation, that difficulties of valuation of property would make the scheme impracticable, that the levy would destroy the capital of the country, that the levy would lead to wholesale deflation and thus to continued depression and unemployment.

The plan of the Capital Levy for Great Britain seeks to decrease the national debt by 3,000 million pounds. The

The State carries out the conversion of the debt by offering its creditors the choice of repayment or of new securities at a lower rate of interest.

The reduction in the rate of interest by conversion is fair to the creditors for the creditors are allowed the alternative of getting back the principal of the debt. And the advantage of conversion to the tax-payers is that it reduces the burden of interest to be paid by the state and relieves the tax-payers. The finance minister as the guardian of the interests of tax-payers should always be on the look-out to see whether conversion is possible and when it is possible, he should carry it out to relieve the tax-payers' burden as far as possible.

Certain general considerations should guide the finance minister in his work of conversion, namely, conversion can be successfully carried out when the credit of the Government is good. Punctual payment of interest on the public debt by the Government, suitable provisions for debt redemption and generally speaking efficient management of the debt improve the credit of the Government and make conversion possible. Some other rules laid down by financiers are -- the beginning of a period of prosperity is often the best time for a conversion because then the rate of interest is low. The scheme should be made simple so that it will be readily understood by the people and the conversion will thus be made successful.

tax would be levied on capital owned by individuals and graduated according to the amount possessed. Those owning less than 5,000 would be totally exempt, as otherwise the tax would be too expensive to collect. The 300,000 or 400,000 liable would constitute a manageable number. The tax could be paid in cash, or in war Loan or in stocks and shares or in instalments spread over a number of years.

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